TrendMacro

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TRENDMACRO LIVE!

On the December FOMC

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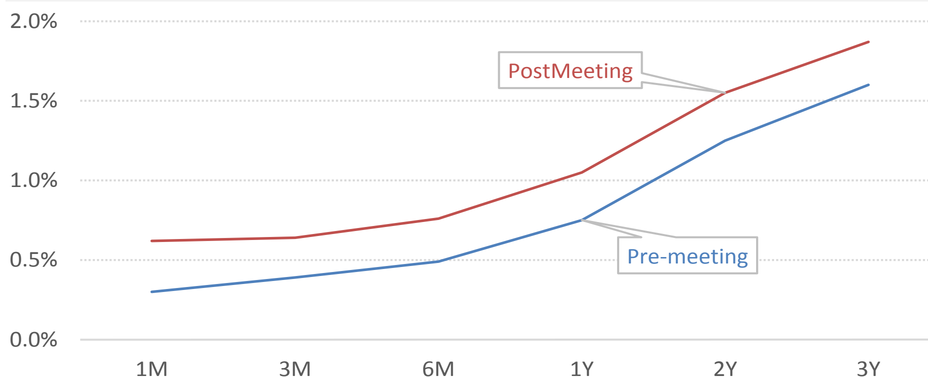
The funds rate is hiked, but the dots go down. It's a mistake, but at least a gentle one.

No surprise that the Fed activated "liftoff" today. Five things matter now, going forward:

- What are the Fed's intentions for the shape, speed and terminal point of this tightening cycle?
- Since the Fed's stated reasons for doing this are so transparently absurd – in the face of so many solid reasons for *not* -- is there some unspoken *true* reason that markets ought to be worried about?
- Will it even work? Will interest rate markets respond to "liftoff"? It's not certain, considering that this is the first-ever rate hike with the Fed paying interest on reserves, doing reverse repos with non-bank counterparties, and operating with a massive balance sheet.
- Are there any fragilities in the system of the world, habituated to seven years of zero rates, that will cause breakage in the immediate aftermath of today's hike?
- If we are right that we are already slipping into the first-ever recession caused by too-low oil prices, will this rate hike make matters worse?

THE FED'S INTENTIONS FOR THIS HIKING CYCLE We're not so sure this will be much of a "cycle" – we think today's hike will be the last for a

Market-implied funds rate by tenor



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO, ASIA MACRO, FX: "Liftoff" is a reality. Based on immediate market reaction – stocks higher, long-term Treasury yields unchanged – it would seem that the Fed succeeded in convincing markets that the hiking regime begun today will be data-dependent, gradual and shallow, and will have a low terminal point. All the "dots" came down sharply, and the familiar "38 words" have been replaced with a more nuanced "44 words," assuring a low funds rate basically forever. We continue to believe this rate hike is a mistake, given stresses in credit markets, a slowing in macro statistics and falling long-term inflation expectations, and expect it will be reversed. With the rationales for "liftoff" so thin, we wonder whether the Fed has a hidden agenda, perhaps trying to get ahead of a gradual de-dollarization in China.

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long time, and indeed will probably have to be reversed (see, among several, "Thank God for Yellen's Conundrum" December 10, 2015). Be that as it may, the key to today's FOMC statement is that it came up with a new version of the 38-word sentence that has appeared over and over, verbatim, *from Janet Yellen's first FOMC statement as chair in March 2014 -- that when the economy is back to normal, the funds rate will stay below normal.* Here, first, are those familiar 38 words, with the essence of the policy message called out in red.

- **The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.**

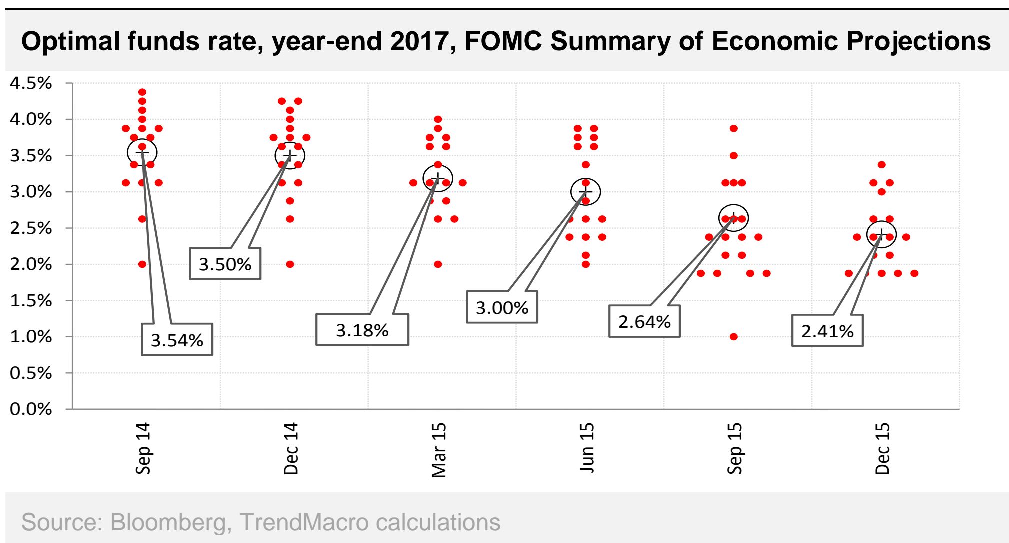
Here is the new language – 44 words, which we expect to see in many FOMC meetings to come.

- **The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.**

Broadly, markets have known this all along. Coming into this meeting, the market-implied funds rate three years out was only 1.60% -- which means, on average, one Fed rate hike every five meetings (please see the chart on the previous page). Those expectations have risen to 1.86% post-meeting, as of this writing. The change may be due, in part, to what is now the ex-post reality of today's hike, as opposed to what was previously only a strong possibility.

- It sure wasn't the "dots" in the FOMC's Summary of Economic Projections, in which the optimal funds rate at all periods, including the longer run, were reduced considerably (see the chart below, and "Data Insights: Federal Reserve" December 16, 2015).

Optimal funds rate, year-end 2017, FOMC Summary of Economic Projections



Source: Bloomberg, TrendMacro calculations

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Recommended Reading

The Bizarre Theory That Says Fed Increases Will Spur Inflation
Alexandra Scaggs
Bloomberg Business
December 15, 2015

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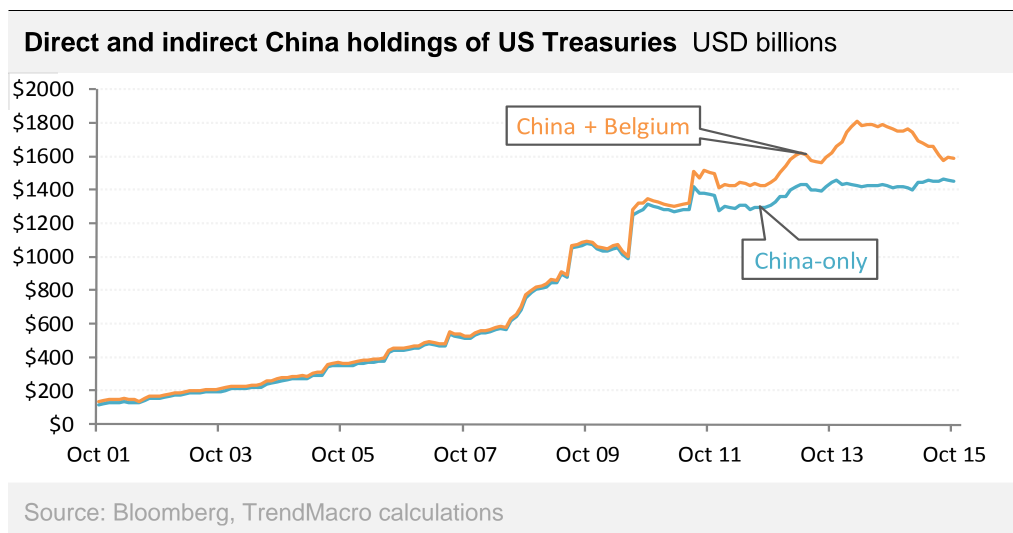
WHY, DEAR GOD, WHY? The economy is stalling, credit markets are under stress, the labor market isn't as strong as headline statistics paint it, and even if it were, that wouldn't necessarily lead to inflation, long-term expectations for which are at or near all-time lows. So why, we have often asked – other than to soothe the wounded pride of an ailing Janet Yellen – is the Fed hiking today (see, among many, "On the October FOMC" October 28, 2015)? Is there some other better reason that the Fed isn't willing to tell us?

- Our only candidate explanation – and this is completely unconfirmed by Fed sources – is that the Fed is mindful of the epoch-making changes around the Chinese currency. We have speculated recently that China's recent devaluation, the RMB's accession to the IMF Special Drawing Rights basket, and the notable decline in China's foreign reserves are shots across the bow indicating a long-term intention by China to de-dollarize, which would entail sale of its Treasury holdings and the liquidation of the dollars raised from their sale (please see the chart below, and "On the RMB Devaluation" August 11, 2015).

Direct and indirect China holdings of US Treasuries USD billions



Source: Bloomberg, TrendMacro calculations

- *If China were to disgorge its vast dollar holdings, that would accelerate the global velocity of dollar money, leading to an inflationary boom. Such a regime is fraught with unknown unknowns, but for whatever good elements it may contain, it would surely be inflationary – so perhaps the Fed is making today a pre-emptive down-payment on dealing with it.*

WILL IT WORK? Market interest rates went to zero on the day Lehman failed in mid-September 2008, when the funds rate was 2%. The funds rate wasn't lowered to zero until the December 2008 FOMC meeting, three months and two meetings later. So obviously there are times when the Fed is not in control.

- Who knows? The funds market has been moribund for seven years. With the banking system awash in excess reserves created

by quantitative easing, it's not obvious that there is any particular reason why it should spring back to life with this rate hike.

- The Fed has already announced that the primary policy tool will be the rate of interest paid on reserves. The Fed never paid interest on reserves at all until late 2008, so today's hike in that rate from 25 bp to 50 bp is the first such hike in history. We simply have no idea how the banking ecosystem will react to that.
- The Fed will also use reverse repos with non-bank counterparties, for the first time in history.
- And all of these first-ever experiments will take place with a balance sheet of unprecedented scale and composition.
- In other words, "liftoff" is really more like the first "takeoff" of an experimental jet fighter – some hero with the right stuff has to take that bird up for the first time, and it will either fly or it won't. Chair Yellen, I knew Chuck Yeager. And you are no Chuck Yeager.

WILL IT BLOW UP? As with the decision not so save Lehman Brothers, in which policy makers never even considered the systemic consequences of the default of Lehman's commercial paper, we can't know what might go wrong here. Let us just say that the only two words in economics that are perfectly true are: *we'll see*.

WILL THIS HELP OR HURT GROWTH? Many economists we respect, and many clients we respect even more, argue that "liftoff" will be good for growth, for various reasons. We don't doubt that there are pro-growth elements to it, but the effect on the economy will be the net of *all* the elements, pro-growth and anti-growth. *With all due respect to those who differ with us, and with respect to how little any of us know about any of this at this point, we have to come back to basics, and those basics tells us that this is a mistake, and that it will hurt growth.*

- For us, the basics are pretty simple. There is a natural rate of interest. Yellen referred to this concept in the preamble to today's press conference. When the Fed sets rates above the natural rate, it moves the economy toward deflation. When the Fed sets rates below the natural rate, it moves the economy toward inflation. Both inflation and deflation hurt growth, so the Fed's policy rate should equal the natural rate.
- The natural rate is unobservable, so perhaps this isn't helpful.
- But for what it's worth, model-based attempts to observe it – or its close counterpart, the "neutral" rate – suggest that it's not much different now than zero.
- We normally don't cite New York Fed President William Dudley as an authority on anything, but we have to note that even he admitted last month, "…current short-term real interest rates are not far below their neutral counterparts, suggesting that the current monetary policy stance is not exceptionally stimulative."
- *So if rates are already basically normal, why "liftoff" today in an effort to normalize?*
- *So if there are stresses in credit markets, turmoil in currency markets and a plentitude of evidence that the already tepid growth*

seen since the end of the Great Recession is slowing, why “liftoff” at all?

- Unless you accept some explanation outside the explicit domain of the statements the Fed has made – such as our speculation about China – then the only answer that “why” is that there is no reason why, and that this therefore is a mistake.
- This mistake will exacerbate that we think is already the first-ever recession caused by too-low oil prices. It will be reversed, like they all have been in the Not So Great Recovery following the Great Recession.

Bottom line

“Liftoff” is a reality. Based on immediate market reaction – stocks higher, long-term Treasury yields unchanged – it would seem that the Fed succeeded in convincing markets that the hiking regime begun today will be data-dependent, gradual and shallow, and will have a low terminal point. All the “dots” came down sharply, and the familiar “38 words” have been replaced with a more nuanced “44 words,” assuring a low funds rate basically forever. We continue to believe this rate hike is a mistake, given stresses in credit markets, a slowing in macro statistics and falling long-term inflation expectations, and expect it will be reversed. With the rationales for “liftoff” so thin, we wonder whether the Fed has a hidden agenda, perhaps trying to get ahead of a gradual de-dollarization in China.